No. 18,258

In the United States Court of Appeals for the Ninth Circuit

McCullough Tool Company, petitioner

v.

Commissioner of Internal Revenue, respondent

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 32-48) is reported at 33 T.C. 743.

JURISDICTION

This petition for review (R. 52-54) involves federal excess profits taxes for the years 1951 and 1952. On January 9, 1957, the Commissioner of Internal Revenue mailed to the petitioner, McCullough Tool

Company, a notice of deficiency (R. 14-23) in the respective amounts of $104,690.01 and $86,898.80. Within ninety days thereafter and on April 8, 1957, the petitioner filed a petition with the Tax Court (R. 1-13) for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. The decision of the Tax Court, determining deficiencies for the years 1951 and 1952 in the respective amounts of $126,104.46 and $740.52, was entered April 12, 1962. (R. 51.) The case is brought to this Court by a petition for review filed July 9, 1962. (R. 52-55.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether certain fixed amounts, which the petitioner-corporation (taxpayer herein) had agreed to pay under modification agreements which purported to convert two patent licensing agreements into sales of the patents, could, in computing its excess profits tax credit, be treated as "borrowed capital", within the meaning of Section 439 of the Internal Revenue Code of 1939, in that the agreement to pay these amounts represented an unconditional "outstanding indebtedness" which was evidenced by one of the types of instruments prescribed in the statute—specifically, here, a promissory note.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 436 [as added by Sec. 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

(a) *General Rule.*—In the case of a domestic corporation (except a corporation described in subsection (b)) the excess profits credit for any taxable year computed under this section shall be the sum of the following:

(1) The invested capital credit computed under section 437, reduced by the amount computed under section 440(b) (relating to inadmissible assets), and

* * * *

(26 U.S.C. 1952 ed., Sec. 436.)

SEC. 437 [as added by Sec. 101, Excess Profits Tax Act of 1950, *supra*]. INVESTED CAPITAL CREDIT.

(a) *Definition.*—The invested capital credit for any taxable year shall be the amount shown in the following table:

If the invested capital for such year (as defined in subsection (b)(1)) is:	The credit shall be:
Not over $5,000,000	12% of the invested capital.
Over $5,000,000 but not over $10,000,000	$600,000, plus 10% of the excess over $5,000,000.
Over $10,000,000	$1,100,000, plus 8% of the excess over $10,000,000.

(b) *Invested Capital.*—

(1) *Election of taxpayer.*—The invested capital for any taxable year shall be the adjusted invested capital determined under paragraph (2), except that if the taxpayer elects in its return for such taxable year to compute its invested capital under the provisions of section 458, the invested capital for such year shall be the historical invested capital determined under section 458. For the invested capital of certain insurance companies, see paragraph (3).

(2) *Adjusted invested capital.*—The adjusted invested capital for any taxable year (hereinafter in this paragraph referred to as "the taxable year") shall be the sum of—

* * * *

(C) 75 per centum of the average borrowed capital for the taxable year computed under section 439(a); and

* * * *

(26 U.S.C. 1952 ed., Sec. 437.)

SEC. 439 [as added by Sec. 101, Excess Profits Tax Act of 1950, *supra*]. BORROWED CAPITAL.

(a) *Average Borrowed Capital.*—For the purposes of this subchapter, the average borrowed capital for any taxable year shall be the aggregate of the daily borrowed capital for each day of such taxable year, divided by the number of days in such taxable year.

(b) *Daily Borrowed Capital.*—For the purposes of this subchapter, the daily borrowed capital for any day of any taxable year shall be

determined as of the beginning of such day and shall be the sum of the following:

> (1) The amount of the outstanding indebtedness (not including interest) of the taxpayer, incurred in good faith for the purposes of the business, which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebteness, mortgage, deed of trust, bank loan agreement, or conditional sales contract. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 439.)

STATEMENT

The facts as stipulated (R. 26-28) and found by the Tax Court (R. 33-41) are as follows:

The petitioner (hereafter referred to as taxpayer) is a corporation organized under the laws of the State of Nevada, with its principal place of business at Los Angeles, California. At all times pertinent herein 80 per cent of the stock of the taxpayer was owned by I. J. McCullough and 20 per cent was owned by his brother, O. J. McCullough. I. J. McCullough and O. J. McCullough are sometimes hereinafter referred to as the McCulloughs. (R. 33-34.)

Since its inception in 1941, the taxpayer has been and is now engaged in the rendition of perforating and other highly specialized services to the oil drilling industry. The business in which the taxpayer is engaged is highly competitive and approximately 75 per cent of such business is founded on a number of patents which it either owns or is licensed to use. (R. 34.)

Prior to January 1, 1944, the McCulloughs were the owners of certain patents (hereinafter referred to as the bullet patents) governing the manufacture, use, and sale of bullet-like projectiles for the perforation of oil wells. (R. 34.)

On January 1, 1944, the taxpayer and the McCulloughs entered into an agreement whereby the taxpayer received an exclusive license to make, use, and sell devices manufactured in accordance with the bullet patents. The agreement provided, *inter alia* (R. 34-36):

> 1.
>
> The Licensors hereby grant to the Licensee, upon and subject to the conditions, covenants, restrictions and terms hereinafter contained, the full and exclusive right and license during the continuance of this agreement to make, use and sell throughout the United States, its territories and possessions, devices made in accordance or disclosed in the aforesaid patents set forth on Exhibit A for the full term of said patents and until the expiration date of the last of said patents.
>
> 2.
>
> It is mutually understood and agreed that the license granted in Paragraph 1 hereof is granted subject to the condition that it does not and shall not empower the Licensee, directly or indirectly, to license any other person or persons, natural or artificial, to use said patents.
>
> * * * *

4.

The Licensee further agrees to keep books, records, and accounts of all work performed during the life of this agreement of all work done hereunder, and all such records or accounts shall at and during the usual business hours be open to the inspection of the Licensors or their duly authorized representative.

5.

On or before the 15th day of each calendar month after the execution hereof and during the continuance of this agreement, the Licensee shall mail a statement to each of the Licensors containing the information required in Paragraph 4, hereof, showing all charges for use and sales by the Licensee under this agreement during the next preceeding [sic] calendar month.

6.

In consideration of the rights and licenses herein given and granted by the Licensors to the Licensee, the Licensee agrees to pay to the Licensors at the time of rendering the statement required by Paragraph 5 hereof, a royalty consisting of a sum equal to twelve and one-half per cent (12½%) of the total gross price charged by the Licensee for all gun perforating done and all sales of parts and equipment in accordance with the herein license and patents, and one-fourth (¼) of the said royalty shall be paid to the Licensor O. J. McCullough and three-fourths (¾) of the said royalty shall be paid to the Licensor I. J. McCullough.

7.

The Licensee shall have the right to terminate this agreement upon first giving ninety day notice in writing to the Licensors to cancel and terminate this agreement together with all rights, licenses and obligations hereunder, provided, however, that no such termination or cancellation shall relieve the Licensee from the payment of any royalty due and payable to the Licensors at the time of such termination.

8.

In the event that either party shall violate any covenants of this agreement, the aggrieved party may give to the defaulting party written notice of such breach accompanied by sufficient particulars to reasonably enable the defaulting party to determine the alleged nature and extent of the breach, and if the defaulting party shall fail for a period of thirty days after the service of such notice to remedy such breach, the aggrieved party may, at its option, terminate and cancel this agreement and all of the rights and licenses of any defaulting party hereunder. The waiver of any particular breach or breaches by the aggrieved party shall not be deemed to constitute a waiver of any continuing breach or of any future breach by the defaulting party of this agreement.

On October 1, 1947, the taxpayer entered into an exclusive license agreement with Earl J. Robishaw and William G. Sweetman regarding several patent applications (hereinafter referred to as the jet patents) governing the manufacture, use, and sale of

shaped charges of explosives for the perforation of oil wells, devices sometimes known as jet perforators. The process of jet perforation of oil wells covered by the jet patents was not sufficiently developed at the time of the agreement to be commercially usable. The taxpayer under the agreement undertook the responsibility and expense of further development of the jet patents. In all other material respects the agreement was similar to the agreement for the bullet patents except as to the amount of royalty, the length of periods for notice of termination, and the transferability of the license. The agreement makes no mention of the right to grant sublicenses. (R. 36-37.)

Neither Robishaw nor Sweetman was an employee of the taxpayer on October 1, 1947. (R. 37.)

In July, 1948, each of the McCulloughs acquired a 25 per cent interest in the jet patents. At that time the jet patents were still not commercially usable. (R. 37.)

On December 28, 1950, the McCulloughs and the taxpayer executed a document entitled "Modification Agreement" which provided (R. 37-38):

> WHEREAS, the parties hereto on the first day of January, 1944 did make and enter into an Agreement by which the [McCulloughs] sold to the [taxpayer] certain patents and patent applications listed on Exhibit "A" attached thereto; and
>
> WHEREAS, said Agreement was termed a "License Agreement" and the parties thereto were referred to as Licensors and Licensee, respec-

tively, although the Agreement was intended to be, and, in law, was actually an agreement of sale; and

WHEREAS, Paragraph 6 of said Agreement provided for payments to the [McCulloughs], which payments were termed "royalty", of 12½% of the total gross price received by the [taxpayer] for services and sales under the said patents and patent applications; and

WHEREAS, the parties are desirous of modifying said provision for payment and substituting therefor a fixed and determinable total remaining price to be paid by the [taxpayer] in consideration for the sale of the said patents;

NOW, THEREFORE, in consideration of the mutual promises of the parties hereto, IT IS AGREED AS FOLLOWS:

1. Paragraph 6 of said Agreement of January 1, 1944 is modified to read as follows:

> "6.
>
> "In consideration of the rights in and to the patents and patent applications transferred, assigned and sold by the [McCulloughs] to the [taxpayer], the [taxpayer] hereby agrees to pay to the [McCulloughs], in addition to all other payments heretofore made hereunder, $20,000.00 per month on the 28th day of each calendar month, commencing on the 28th day of December, 1950, for a period of six years and one month. The last of said monthly payments shall be due and payable on the 28th day of December, 1956. One-fourth of each of

said monthly payments, or $5,000.00, shall be paid to O. J. McCullough, and three-fourths of said monthly payments, or $15,-000.00 shall be paid to I. J. McCullough. The parties are agreed that the total of these payments, $1,460,000.00, shall be the full remaining price to be paid by the [taxpayer] for the complete and absolute ownership of the patents and patent applications described in Exhibit "A"."

2. It is agreed by the parties hereto that any and all provisions of said Agreement of January 1, 1944 which are inconsistent with this Modification Agreement shall have no effect. Said Agreement of January 1, 1944 has been considered by the parties thereto as an absolute assignment or sale of the subject matter thereof. That Agreement together with this Modification thereof shall be similarly construed hereafter.

On December 28, 1950, the parties to the jet patent agreement or their assignees entered into similar modification agreements, the effect of which, *inter alia,* was to substitute the total price of $2,870,000 for the payment of a royalty. In all other respects the agreements were almost identical to the modification agreement relating to bullet patents. (R. 38.)

The taxpayer made all payments for the bullet patents due to McCulloughs under the modification agreement. The taxpayer's gross sales of parts and services under the bullet patents; the royalty payable thereon which would have been paid under the agreement of January 1, 1944; the actual payments under the modification agreement; and the excess

of the royalty payments which would have been paid under the agreement of January 1, 1944, over actual payments for the years 1950 to 1958, are as follows (R. 39):

Year	Sales	Royalty	Actual Payments	Excess
1950 (Dec. only)	....	....	$ 20,000.00	$ (20,000.00)
1951	$ 2,073,301.88	$ 259,162.74	240,000.00	19,162.74
1952	2,311,565.79	288,945.72	240,000.00	48,945.72
1953	2,908,134.84	363,516.86	240,000.00	123,516.86
1954	3,140,828.54	392,603.57	240,000.00	152,603.57
1955	3,268,037.83	408,504.73	240,000.00	168,504.73
1956	3,948,232.27	493,529.03	240,000.00	253,529.03
1957	2,688,173.28	336,021.66	....	336,021.66
1958	2,250,591.30	281,323.91	....	281,323.91
	$22,588,865.73	$2,823,608.22	$1,460,000.00	$1,363,608.22*

* Under the Modification Agreement of December 28, 1950, the fixed payment terminated December 1956. Under the prior License Agreement of January 1, 1944, the royalty payments would have continued until approximately 1968.

The taxpayer has made all payments for the jet patents due to the owners or assignees under the modification agreement. The taxpayer has made no attempt to terminate the agreement and in 1952 made advances to one of the parties of payments due for the five years next ensuing. The taxpayer's gross sales of parts and services under the jet patents; the royalty payable thereon if such royalty payments had been made under the agreement of October 1, 1947; the actual payments made under the modification agreement; and the excess of the royalty payments which would have been made under the contract of October 1, 1947, over actual payments for the years 1950 to 1958, are as follows (R. 39-40):

Year	Sales	Royalty	Actual Payments	Excess
1950 (Dec. only)	....	....	$ 14,000.00	$ (14,000.00)
1951	$ 2,391,904.25	$ 239,190.43	168,000.00	71,190.43
1952	2,953,871.53	295,387.15	168,000.00	127,387.15
1953	3,323,230.48	332,323.05	168,000.00	164,323.05
1954	3,478,612.41	347,861.24	168,000.00	179,861.24
1955	4,012,038.67	401,203.87	168,000.00	233,203.87
1956	4,490,768.51	449,076.85	168,000.00	281,076.85
1957	3,799,971.39	379,997.14	168,000.00	211,997.14
1958	3,569,073.75	356,907.38	168,000.00	188,907.38
	$28,019,470.99	$2,801,947.11	$1,358,000.00	$1,443,947.11

The Tax Court (R. 48) sustained the determination of the Commissioner that the taxpayer is not entitled to include its obligation under the modification agreements of 1950 as "borrowed capital" for the purpose of computing its excess profits tax credit. The taxpayer brings that decision here for review.

SUMMARY OF ARGUMENT

In order to qualify as "borrowed capital" under the provision of Section 439 of the Internal Revenue Code of 1939, and thus to be includible in the computation of the taxpayer's excess profits tax credit, an obligation of the taxpayer must be an unconditional outstanding obligation and it must be evidenced by one of the nine instruments named in the statute. The obligations created in the instant modification agreements of December, 1950, were neither.

It is well established, and apparently conceded by the taxpayer, that the existence of a right in the obligor to terminate the agreement out of which his obligation grows, and, thus, to abrogate any part

of the stated obligation destroys its nature as an unconditional obligation and excludes it from treatment as an "'outstanding obligation" within the meaning of the statute. Such a termination right was included as paragraph 7 of the original agreements of January 1, 1944, and October 1, 1947, and remained unchanged in the agreements as modified in December, 1950. The taxpayer seeks to avoid the condition which this imposes on its obligation by arguing that this right was abrogated by the blanket provision of the modification nullifying all provisions of the original agreement which were inconsistent with it . It is suggested by the taxpayer, without supporting authority, that a right of termination is, of necessity, inconsistent with an agreement of purchase of sale. On the contrary, there is ample authority, both federal and state, to the effect that a contract for the sale of property may, and frequently does, contain a termination right (or its equivalent —the right to require the vendor to repurchase) running in favor of the vendee. Furthermore, the modification agreement itself is replete with attestation that the earlier agreements were, just as was the modification, intended as agreements of sale. It necessarily follows from this that the termination rights, having been made a part of the original agreements, were intended to condition an agreement of sale and cannot have been intended to be, or regarded as, in conflict with the modified agreements which merely reaffirmed the nature of the original agreements.

The obligation also falls short of qualifying as "borrowed capital" because not evidenced by one of the prescribed instruments. The contract giving rise to the obligation cannot constitute a "note", first, because the agreement to pay, contained therein, is not unconditional (one of the most definitive characteristics of a note) and, second, because a contract is not, by normal usage and terminology, a "note", the established rules of interpretation requiring that this be the standard by which this statutory term be construed.

ARGUMENT

The Amounts Which the Taxpayer Was To Pay Under the Modification Agreements Could Not Be Treated As "Borrowed Capital", Within the Meaning of Section 439 of the Internal Revenue Code of 1939 Since (1) They Did Not Represent An Unconditional Obligation and (2) Were Not Evidenced By One of the Types of Instruments Prescribed In the Statute

The issue before the Court centers about the proper computation of the taxpayer's excess profits tax liability for the years 1951 and 1952. Particularly, the question has to do with the excess profits tax credit which the taxpayer may use to reduce the amount of the net income against which the excess profits tax is charged. One of the elements which the taxpayer may include in developing its excess profits tax credit is the amount of its "borrowed capital", as defined in Section 439, *supra.* The instant litigation is immediately concerned with the provision of Section 439(b)(1) which provides that "borrowed capital" shall include:

> (1) The amount of the outstanding indebtedness (not including interest) of the taxpayer, incurred in good faith for the purposes of the business, which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sales contract. * * *

The taxpayer, a corporation which provided a service known as the perforation of oil wells, acquired the patent rights to two perforation devices (known as the "bullet" and the "jet") from several individuals. The "bullet" process was transferred to the taxpayer by the McCullough brothers, who were also the owners of 80 per cent of the taxpayer's stock. Both patents were initially acquired by what purported to be licensing agreements which were later modified by agreements designating the transfers as "sales" of the respective patent rights and converting the mode of payment from royalties, based upon the receipts produced by the patented devices, to fixed purchase prices, payable in installments over a five-year period. It is the contention of the taxpayer, rejected by both the Commissioner and the Tax Court, that the amount of the respective sale prices constitute "outstanding indebtedness" within the meaning of Section 439(b)(1), *supra*.

As pointed out by the Tax Court (R. 44) and agreed to by the taxpayer (Br. 14), in addition to being an "outstanding indebtedness", an obligation must be evidenced by one of the types of instruments named in Section 439(b)(1) in order to qualify as

"borrowed capital". The taxpayer contended below that the modification agreements, taken together with the earlier instruments which they modified, each constituted either a "note" or a "conditional sales contract"—these being two of the instruments named in the statute. The Tax Court held (R. 45-48) that they were neither and, having found them disqualified on that ground, did not undertake to determine whether or not they met the test of being "outstanding indebtedness". We submit that the Tax Court was correct in holding that the agreements did not constitute a "note" [1] and, moreover, that they did not represent "outstanding indebtedness" and were, thus, barred on both grounds from being treatable as "borrowed capital".

A. *The agreements did not constitute "outstanding indebtedness"*

The taxpayer concedes (Br. 15), citing cases, that, to be an "outstanding indebtedness" within the meaning of Section 439 (b) (1), an obligation must be unconditional—that is, it must be payable under all circumstances and subject to no contingency and no option, particularly on the part of the alleged debtor. Despite the contentions to the contrary by the taxpayer (Br. 16-19), the agreements here involved did not create an unconditional obligation on the part of the taxpayer to pay the amounts of $1,460,000 and $2,870,000, named, respectively, in the two modifica-

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[1] The taxpayer does not renew before this Court the claim that the agreements amounted to a "conditional sales contract".

tion agreements of December 28, 1950. This is because the obligations in question were conditioned by the right of the taxpayer to terminate the agreement, at will, upon 90 days' written notice (par. 7, R. 36) and thus to abrogate any liability on its part to make any further payments under the agreement except those already *due and payable* at the time thereof. It is to be noted in this connection, that, under the modification agreement (R. 38), the full price was to be paid in monthly installments, that $20,000 was payable on the 28th of each month commencing on December 28, 1950, and that "The last of said monthly payments shall be *due and payable* on the 28th day of December 1956." (Emphasis added.) Consequently, the taxpayer had the option, at any time between December 28, 1950, and December 28, 1956, of relieving itself of the obligation to make any further monthly payments by giving written notice to the patentees of its intention to terminate the agreement.

The taxpayer seeks to avoid the effect of this provision by referring (Br. 17) to the language of paragraph 2 of the Modification Agreement (Br. 38) which reads:

> It is agreed by the parties hereto that any and all provisions of said Agreement of January 1, 1944 [and of that of October 1, 1947] which are inconsistent with this Modification Agreement shall have no effect.

It appears to be the taxpayer's contention (Br. 16-17) that, because the modification agreements pur-

ported to create a sale of the patents, the termination provisions of the earlier agreements became inconsistent therewith and were nullified by the above provision. This conclusion is entirely arbitrary and self-serving and the taxpayer makes no effort to show wherein lies the inconsistency. In fact, we submit, there is no inconsistency at all and as we shall show, the parties themselves obviously did not so regard or intend it at the time the agreements were drafted and executed.

1. The basis of the taxpayer's contention appears to rest upon the unspoken assumption that a contract of sale can never contain a provision for termination and that any such provision would, of necessity, be inconsistent with the concept of a sale. The taxpayer cites no authority in support of such an assumption. On the other hand, there is ample authority to the contrary. In *Myers* v. *Commissioner*, 6 T.C. 258, there was involved a contract using words of license similar to that contained in the original agreements in the instant case and, similarly, transferring all of the substantial rights inherent in the patent. The court, following the rule laid down by the Supreme Court in *Waterman* v. *Mackenzie*, 138 U.S. 252, held that this amounted to a sale of the patent. The agreement in the *Myers* case contained termination rights running to both parties. The right of the licensee was very similar to that here involved, providing (p. 260):

> 10. The Licensee shall have the right to terminate this agreement as to any letters patent

> included hereunder at any time after December 31, 1932, by sixty (60) days written notice mailed to the Licensor at his last known home address, or otherwise delivered to him, without, unless so specified by the Licensee, terminating it as to other letters patents included in the license herein granted, and the agreement and the license herein granted shall automatically terminate upon the expiration of all letters patents included hereunder, and/or upon the abandonment of any application included hereunder.

As to this, the Commissioner had contended (p. 264) that "The reservation of both the Licensor and the Licensee to terminate the agreement is incompatible with the claim that a sale was made." The court ruled (p. 264) that these were conditions subsequent which *did not interfere* with the passing of ownership.

This compatibility is reflected in the decisions of the state courts, including those of California. In a note in 44 A.L.R. 2d 343-344, dealing with provisions for repurchase by the vendor in contracts for the sale of property,[2] it is said that:

> It is clear that the parties to a contract for the sale of land, or to a conveyance of land, may validly provide, in the instrument of contract or conveyance, or by a contemporaneous writing, * * * that the vendee shall have an option to require the vendor to repurchase * * *.

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[2] There can be no difference, with respect to the question at hand, between the right to terminate or rescind and the right to require repurchase.

Hull v. *Angus*, 60 Ore. 95, 118 Pac. 284, 287, involved a conveyance of real property with part of the purchase price paid in cash and a note, secured by a mortgage, given for the balance. The note contained a proviso that made it liable to the terms of the mortgage and the latter reposed in the maker-mortgagor the right to cancel the sale and the note. This right was held to have destroyed the unconditional nature of the note and existed with respect to a purchase and sale transaction.

In *Hale* v. *Pendergrast*, 42 Cal. App. 104, 183 Pac. 833, 835, there had been a sale and conveyance of real property for $10,000 of which $2,000 was paid in cash and a note and mortgage issued for the $8,000 balance. The contract of sale provided that the vendee had the right within one year to demand that the vendor repurchase. The right was exercised within the time allowed but after the vendor had sold the note and mortgage to a third party without notice of the repurchase provisions. The latter ultimately brought suit against the vendee for the face amount of the note. The Supreme Court of California ruled in a *per curiam* opinion (pp. 110-111) that the assignee, although he might, because of the absence of notice to him, foreclose against the property, had no right to a deficiency judgment on the note. Thus, the termination or repurchase right was held valid, even in a contract of sale and conveyance, and its existence destroyed the unconditional nature of the promise to pay contained in the note.

In *Van Demark* v. *California Home Extension Ass'n*, 43 Cal. App. 685, 185 Pac. 866, it was recognized that a contract of sale may provide the vendee with a right to return the purchased property upon his own subjective determination that he is dissatisfied with it. Obviously, a note issued to the vendor in whole or partial payment for such property could not be unconditional in the face of such a provision —identical, in effect, with the right granted to the instant taxpayer by paragraph 7 of the original agreements of January 1, 1944, and October 1, 1947. See, to the same effect, *Bank of Claflin* v. *Rowlinson*, 2 Kan. App. 82, 43 Pac. 304.

2. It is clear from the terms of the several agreements that the termination provisions could not have been inconsistent with the terms of the modified agreements since the modifications made no change which affected those provisions. The "Whereas" clauses of the modification agreements (R. 37) recite that, by the earlier agreements, the patentees had "sold" the patents to the taxpayer, that they had been *intended* as agreements of *sale* and that, in law, they constituted such agreements. Since the modification agreements expressly provided for the same effect, there is no possible reason why the termination provisions should be any more inconsistent with them than with the original agreements of which they were a part. Further, if, as recited, the earlier agreements were *intended*, when executed, to effect a sale of the patents and the termination provisions were part of the instruments framed and executed to carry out this intent, it becomes obvious that they

were not then regarded as inconsistent with the purpose to effect a sale and conveyance. That being so, it is difficult to see how they could have been, or why they should be, regarded as inconsistent with the later agreement which purported to do, and did, nothing but affirm this purpose.

The final "Whereas" clause (R. 37) states that the purpose of the modification agreement is to substitute a fixed price for the existing payments which had been based upon the taxpayer's receipts from use of the patents. The agreement itself carries out this intent by changing only the language of paragraph 6 which deals with nothing but the mode of payment. Since the termination provision is equally consistent with any mode of payment, it cannot be inconsistent with the altered mode and the taxpayer makes no attempt to explain why it should be so regarded. In this respect, it may be noted that the very paragraph of the modification agreements (R. 38) which nullifies inconsistent provisions also reaffirms that the parties considered the earlier agreements (containing the termination provision) as of the same nature (agreements of sale) as the modified agreements.[3]

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[3] That the mere change in the mode of payment worked no real change in the nature and effect of the original agreements is emphasized by reference to the 1956 amendment (Act of June 29, 1956, c. 464, 70 Stat. 404) which added Section 117(q) to the 1939 Code and made retroactive to tax years beginning after May 31, 1950, the provisions of Section 1235 of the 1954 Code (26 U.S.C. 1958 ed., Sec. 1235). It is made clear there and in the Committee Report

Apart from the above, we submit that, had the parties to the modification agreements intended to effect so substantial a change as to eliminate the termination rights, they could easily, and would surely, have so provided in clear and specific language rather than through an uncertain reference to "all provisions * * * which are inconsistent".

The taxpayer suggests (Br. 19) that the ruling of the Tax Court (which is not brought here by the Commissioner for review) that it was entitled, under Section 23(l)(1) of the 1939 Code, to take depreciation deductions against its cost basis in the patent rights represents a determination that the modification agreements "established a fixed and unconditional obligation on the part of the [taxpayer]." The presumption implicit in this contention, and the above language, is that all fixed obligations are necessarily unconditional. We submit that this is not so. It should be noted that the Tax Court did not, with respect to this question, consider whether the obligation was or was not unconditional. (R. 41-43.) It stated the position of the Commissioner to be (R. 42) that depreciation was not allowable because the taxpayer did not have a *fixed* cost basis. The two terms operate independently and refer to different considerations. The term "fixed" refers to the determinability of the *amount* payable under an agree-

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accompanying the bill (H. Rep. No. 1607, 84th Cong., 1st Sess. (1956-2 Cum. Bull. 1226)) that the mode of payment for the rights to a patent are to have no bearing on the question of whether a given transfer of such rights constitutes a sale of the patent or a licensing arrangement.

ment. The term "conditional" refers to the degree of certainty or immutability attaching to the obligation to pay that amount. Thus, a licensing agreement, without termination rights, may establish an unconditional obligation to pay amounts which, because dependent upon variables, is not known or fixed. On the other hand, as in the instant situation, the amount may be known and thus "'fixed" but there may exist conditions in the agreement under which all or part of that amount may never become due and payable. There is nothing in the statutory provision for depreciation deductions which prohibits the depreciation of a cost basis in property because all or part of that cost might be remitted by the occurrence of a conditional contingency—upon the happenings of which any excessive depreciation deductions would presumably be taken into account in computing the tax consequences of the transaction by which the condition was made effective.

The Tax Court (R. 42) apparently interpreted the Commissioner's opposition to the allowance of depreciation to be on the ground that the 1950 modification agreement (and the fixed payment there provided) was a nullity because the "sale" there provided for had already taken place by operation of case law. It disposed of the issue on the sole conclusion (R. 42-43) that, even so, the surrender of the royalty payments and the assumption of the obligation to pay the fixed amount were mutually supporting considerations which established a valid modification to the agreement. The effect of the termination provision did not enter the picture.

Moreover, even if depreciation allowances were not deductible where a condition attaches to the taxpayer's obligation to pay the amounts established as the cost to it of the property, the validity and subsistence of the condition in the modified agreement is not open to question, as has been shown above. Therefore, the obligation could not amount to an "outstanding obligation" under the provision of Section 439(b)(1) and it would be necessary to conclude that the Tax Court had erred in allowing depreciation deductions to the taxpayer.

B. *The instruments which evidenced the taxpayer's obligations were not "notes"*

The Tax Court ruled (R. 47) that the taxpayer's obligations under the patent transfer agreements were not evidenced by a "note" within the meaning of Section 439(b)(1), *supra*, holding, apparently, that the issue was controlled by the rule in *Journal Publishing Co.* v. *Commissioner*, 3 T.C. 518, although recognizing that the contracts involved in the two cases were somewhat different.

As shown by the authorities cited by the taxpayer (Br. 20), a "note" creates an unconditional obligation to pay the named amount. In *Journal Publishing Co.* v. *Commissioner supra*, the parties had contracted for the sale to the taxpayer of certain physical assets of another publishing company and for a covenant by the latter not to compete. The contract provided for a $50,000 payment for the assets and $470,000 for the covenant. There, the Tax Court held that the taxpayer's obligation to pay the above

amounts did not amount to an unconditional promise and that the contract could not constitute a "note" for the purposes of Section 719(a)(1), the precursor provision to Section 439(b)(1).[4] In support of this holding, the court pointed to the fact that the promisee had a continuing obligation to refrain from the proscribed competitive activity and that failure to conform would relieve the taxpayer of its obligation to make payments. In the instant case, the taxpayer's right (as demonstrated in A, above) to terminate the agreement and, thereby, to discharge itself from the obligation to make further monthly payments, had, as recognized by the Tax Court, the same effect and placed conditions upon the taxpayer's agreement to pay. For this reason, alone, the Tax Court's holding that the composite agreement did not constitute a "note" was correct and should be sustained.

But, we submit, further, that a contract, whether unilateral or bilateral, is not a "note" within the normal usage of the latter term and, for that reason, is not comprehended within the coverage of that term as used in Section 439(b)(1). It has been frequently observed that the designation by the Congress of specific evidences of indebtedness in the statutory provision here involved, and in those in which simi-

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[4] Section 719(a)(1) was added to the Internal Revenue Code of 1939 by the Second Revenue Act of 1940, Section 201, c. 757, 54 Stat. 974, and repealed by Section 122(a), Revenue Act of 1945, c. 453, 59 Stat. 556. It was restored in substantially identical form by Section 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137.

lar language has been used, was intended to include only instruments of that precise nature and not others which, although sometimes similar in result, are known by other terms, and which Congress could have included had it wished to do so, either by specific designation or by use of general language which would also cover them. *Journal Publishing Co.* v. *Commissioner, supra; West Construction Co.* v. *Commissioner*, 7 T.C. 974; *Bernard Realty Co.* v. *United States*, 188 F. 2d 861 (C.A. 7th); *Consolidated Goldacres Co.* v. *Commissioner*, 165 F. 2d 542 (C.A. 10th). This was developed in considerable detail in *Journal Publishing Co., supra.* There the court pointed out (p. 522) that in other statutory provisions, and in Treasury Regulations, where, as here, the definition of "indebtedness" was involved and where the term was defined by listing the specific types which were to be covered, there was sometimes added the phrase "or other evidence of indebtedness", while in other instances it was omitted. The court then observed that, in Section 719(a)(1) (the World War II version of the section here involved), the Congress had omitted the general phrase and that, therefore (p. 523), "section 719(a)(1) must be applied in the instant case without the benefit of the additional phrase urged by the petitioner, * * * and that borrowed capital must be evidenced by the specific type of instruments set forth in the statute."

In *Consolidated Goldacres Co.* v. *Commissioner, supra.*, the Tenth Circuit announced (p. 545) that:

> * * * the Congress has deliberately chosen words to define the type of "outstanding indebtedness" which will be included in the excess profits credit, *and those words should be given their ordinary meaning in common usage.* (Emphasis added.)

This proposition has also been stated by the Seventh Circuit (*Bernard Realty Co.* v. *United States, supra*) which said (p. 864):

> * * * since Congress did not define "note" and "mortgage" in sec. 719, we hold it was intended that these terms be considered according to their ordinary legal acceptation.

The Seventh Circuit further ruled (p. 863) that:

> Taxpayer is claiming a credit or exemption, and is subject to the well established rule that a claimed credit, privilege or exemption from a tax cannot be granted unless specifically authorized by Congress, and that taxpayer must bring himself squarely within the terms of the authorizing statute.

We submit that a contract is not a "note" within the "ordinary meaning" of that term "in common usage" nor within the "ordinary legal acceptation", but rather is one of those "other written evidences of indebtedness" which were specifically omitted from the coverage of Section 719(a)(1) and its successor, Section 439(b)(1). To force a contract within the coverage of the term "note" is to violate the above-stated rule that a taxpayer seeking a credit against his taxes must bring himself *squarely* "within the terms of the authorizing statute."

It does not suffice that a contract, which does not have the same connotation as a "note" within the ordinary understanding and usage of the terms, may, in a given instance, posses most or all of the elements held essential in a "note". It remains, in essence, a contract and not a "note". Had Congress wished to confer status as a covered evidence of indebtedness upon any instrument having the characteristics or containing, by happenstance, all of the prescribed qualities of a note, it could readily have so provided through apt language. It is possible that this could have been accomplished through the inclusion of the oft-used phrase "or other written evidences of indebtedness". But, the Congress, in this instance chose not to do so. Had Congress wished to cover all evidences of unconditional indebtedness, it could have used *that* comprehensive expression instead of laboriously listing a certain group of covered instruments, many of which differ from others in only minor particulars. It must have been within the awareness of the legislature in drafting the instant measure that written, unilateral contracts frequently contain the elements of a note. Yet, although the Congress has seen fit, in Section 439(b)(1), to add the "conditional sales contract" to the list of qualifying evidences of indebtedness which had appeared in its predecessor, Section 719(a)(1), it has never listed contracts, generally, or any form thereof, except the special form above noted.

The Tenth Circuit, in *Consolidated Goldacres Co.* v. *Commissioner, supra,* pp. 545-546, said with respect to an instrument, denominated a conditional sales

contract, but which the taxpayer urged had all the characteristics of a mortgage (this case being governed by the provisions of Section 719(a)(1) which, unlike its successor, Section 439(b)(1), named mortgages as an acceptable evidence of indebtedness, but not conditional sales contracts):

> It is true, as pointed out by Consolidated, that in terms of liability imposed, there may be little, if any, distinction or difference between the legal relationship created by a mortgage and a conditional sales contract. Both instruments are intended to provide a measure of security for the performance of an incurred obligation, but they are not used synonymously or interchangeably to describe or define the legal relationship created thereby.

The court went on to say that this fact is especially significant where "it becomes necessary to discern the legislative intention". Thus, where, as here, a contract may, in a given instance be of substantially the same legal effect as a note, nevertheless, it is not a note since the two terms are not used "synonomously or interchangeably" and, when looking to the legislative intent, it must be recognized that the Congress chose to name one but omitted the other. In *Durr Drug Co.* v. *United States*, 99 F. 2d 757 (C.A. 5th), the court observed, in denying a claimed deduction, that the Congress might have provided in appropriate terms for coverage of the situation there at bar but that it had not. And, as the Supreme Court stated in *Deputy* v. *duPont*, 308 U.S. 488, 498, the plain, obvious and rational meaning of the statute

should not be sacrificed, even for the exigency of a hard case.

In *Frankel & Smith Beauty Departments, Inc.* v. *Commissioner*, 167 F. 2d 94 (C.A. 2d), the court had before it the contention that a contractual agreement constituted a note within the meaning of Section 719 (a)(1). In rejecting this argument on the ground that the sum agreed to be paid was not certain, the court observed that its opinion was based on this factor because the Commissioner had not contested the taxpayer's contention that it would otherwise have come within the term, but added that (p. 96):

> We have some doubt as to the correctness of taxpayer's basic contention that, for purposes of Sec. 719(a)(1), any unconditional written obligation, contained in a contract, to pay a sum certain is a "note"; * * *

The Supreme Judicial Court of Massachusetts has drawn a similar distinction in a case (*Burdett* v. *Walsh*, 235 Mass. 153, 126 N.E. 374) involving a contract which provided for the sale of real estate and stock and as to which all provisions had been performed except the payment of $3,000 of the purchase price which was to be accomplished by the issuance of a note in that amount, payable one year thereafter. The note was not issued and the question arose whether the intended payee could recover from a surety which had obligated itself in the event the sum due *under the note* was not paid. The court denied liability, saying (p. 155):

> The fact that the amount payable is precisely the same as if the note had been given cannot make the surety liable for the reason that the liability that it assumed and contracted to meet arose only in case [the debtor] failed to pay the sum due under the note provided for. *A note is not in legal effect the same as an ordinary contractual obligation to pay the amount named therein, even if unnegotiable.* (Emphasis added.)

In *Cobbs* v. *Commissioner*, 39 B.T.A. 642, the Board of Tax Appeals had before it a situation where the taxpayer had surrendered for its cash value a paid up life insurance and annuity policy as to which, apparently, nothing remained to be done except the payment by the insurance company of its evidenced cash obligation under the policy. The taxpayer claimed that the surrender transaction amounted to a "sale or exchange" of the policy under the provision of Section 117(f) of the 1939 Code, which provided that amounts received upon the "retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation * * * shall be considered as amounts received in exchange therefor." It was the taxpayer's position that the surrender of the insurance policy was essentially the same as the redemption of a bond and was covered, therefore, by the above language. The Board said (pp. 643-644):

> We think, however, that this presses logic too far. It would require a hypothesis that Congress, while using fairly clear language to change the law as to a specified list of securities,

> had intended to include also contracts which for one reason or another had been regarded as somewhat similar. This could easily have been done, if not by express specification in the statute, at least by an omnibus term broad enough to include insurance or annuity contracts. But no term in the paragraph is susceptible of such an interpretation. * * * Indeed, the clear specification of these compels the inference that insurance and annuity contracts were deliberately excluded.

In advancing the argument that the instant agreements must be treated as a "note" within the meaning of the statute, the taxpayer relies upon the decision of this Court in *Oregon-Washington Plywood Co.* v. *Commissioner*, 219 F. 2d 883, and upon *United States* v. *Ely & Walker Dry Goods Co.*, 201 F. 2d 584 (C.A. 8th), and *Strickland* v. *Holbrooke*, 75 Cal. 268, 17 Pac. 204. In each of those cases, the instruments involved were designated as notes and were instruments of the type normally known and referred to as notes. In each, the question was merely whether certain unusual features or sequence of language deprived them of that character. None involved an attempt to treat a contract for the sale of property as a "note". In *Oregon-Washington Plywood Co.* v. *Commissioner*, *supra*, the parties had executed the usual contractual instruments and, *in addition thereto*, there had been issued the usual form of promissory note *to evidence* the debt growing out of the contractual agreement. The issue there was thus entirely removed from that at bar. That this Court ruled, there, that reference might be had to the un-

derlying contracts to supply a certain lack of positive information in the note does not imply that the contract, itself, may be treated as a note in the absence of the latter.

The case of *United States* v. *Ely & Walker Dry Goods Co.*, *supra*, cited by the taxpayer (Br. 21), seems more to conflict with than to support its position. There, the Eighth Circuit, in holding that the instruments in question (a note given to a bank to evidence the taxpayer's obligation on a loan) was a "promissory note" within the meaning of the statutory provision there involved, distinguished several cases where instruments also designated as notes, and having all the elements thereof, were nevertheless held to be corporate securities, for which other provision was made in the statute, because having more of the characteristics of the latter. The court quoted (p. 588) from the Second Circuit's opinion in one of those cases (*General Motors Acceptance Corp.* v. *Higgins*, 161 F. 2d 593) the significant statement that "they [the instruments] were not *merely ordinary promissory notes* evidencing debts arising in the ordinary course of business". (Emphasis added.) Thus, while it is true that the inclusion in what is clearly a "note" of representations and provisions which are not normally elements thereof will not, alone, deprive it of that character, an instrument which goes beyond the elements of a "note", to the extent that it, in fact, conforms to the normal characteristics of another type of instrument which, in common usage and "acceptation", is described other-

wise than as a "note", will not be held to be a "note" within the meaning of a statutory provision incorporating that term and omitting the other. Here, the instruments in question are of the common variety known as a simple contract for the sale of property. There is no reason to believe that the Congress intended to include them within the scope of the specific term "note", by which term they are not usually described, nor should the statutory language be stretched to include them.

Brewster Shirt Corp. v. *Commissioner*, 159 F. 2d 227 (C.A. 2d), also relied upon by the taxpayer may have some tendency to support its position but is, we submit, of dubious authority, the court having reached its conclusion that the obligations involved there amount to "mortgages" within the meaning of the statute by an extremely loose construction of that term which is in conflict with the controlling rules of interpretation generally accepted and followed by the majority, *supra*. The nature of the decision in that case can best be demonstrated by the court's concluding statement that the factoring arrangements there at issue were "equivalent to" an indebtedness evidenced by a mortgage. This is precisely what the majority of authorities, *supra*, say is not sufficient to meet the express requirements laid down in the statute. Normal usage and acceptation does not describe a factoring arrangement as a "mortgage" and there is no reason to believe that the Congress so intended. It should also be noted that the Second Circuit distinguished the contrary holding of

several cases following the majority view only by stating as to each (p. 230) that "No mortgage was involved" and disregarding the underlying principles which produced the results in those cases and which were equally applicable to the term "mortgage" as used in the statute. Finally, the entirely different approach and results in *Frankel & Smith Beauty Departments, Inc.* v. *Commissioner, supra*, decided by the Second Circuit a year after its decision in *Brewster Shirt Corp.*, seem to represent an implicit overruling of the approach taken in the latter.

We do not attempt to distinguish *Aetna Oil Co.* v. *Glenn*, 53 F. Supp. 961 (W.D. Ky.), which, certainly seems to have held that a licensing contract for the use of gasoline cracking patents should be treated as a "note" within the provision of the statute there involved because the agreement contained all the elements required in a promissory note. Nevertheless, we believe that in that case, as in *Brewster Shirt Corp., supra*, the court reached an erroneous result by applying a broad, permissive construction of the language selected by the Congress, rather than requiring the instrument before it to come squarely within that language according to its ordinary usage and acceptation. The square conflict between the rules consistently announced in the previously discussed cases and the approach followed by the District Court in *Aetna Oil Co.* is sharply demonstrated by the language of the latter opinion where the court said (p. 966):

> The use in the statute of the several words "bond, note, debenture, certificate of indebted-

> ness, mortgage, or deed of trust" indicates that *no particular type of a written instrument was required* so long as the indebtedness was actually evidenced by a written instrument of some type containing the elements of an unconditional promise to pay. (Emphasis added.)

As stated heretofore, and as pointed out in the previously cited cases, had the Congress wished to cover *any* written instrument containing an unconditional promise to pay, it could have said so much more simply and in so many words. It is incredible to suggest that it intended to convey this meaning by a specific recitation of certain well known types of instruments, omitting others which, like contracts, also frequently reflect or give rise to such a promise or agreement but which are not customarily designated by any of the included terms.

Finally, we believe that the decision of the Tax Court in *Journal Publishing Co.* v. *Commissioner, supra,* contains rather ambiguous dicta with respect to the question whether any written contract which contains an *unconditional* promise to pay and meets the other requirements of a "note" should be treated as a "note" in applying the instant provision of the statute. True, it distinguished *Aetna Oil Co., supra,* on the ground that, in the latter, there was nothing further to be done by the payee. But, the court did not there necessarily indicate the view that the decision in *Aetna* was correct but merely that its emphasis upon unconditionality confirmed the Tax Court's view that a conditional obligation cannot, in any event, constitute a note. Moreover, earlier in

the opinion (p. 524) the Tax Court had stated that the promise to pay contained in the agreement before it was merely "an element in a bilateral contract" and that payment of the sums called for were "conditioned on the performance by the News Co. of certain promises, namely, to deliver assets *and* to refrain from publishing or otherwise competing with petitioner". (Emphasis added.)

The obligations reflected in the modified agreements of December, 1950, are not eligible to be treated as "borrowed capital" within the meaning of Section 439 because they were, as shown in A, *supra*, terminable at the will of the taxpayer and because, as demonstrated above, they do not come within the statutory term "note" because they were so conditioned and because evidenced by instruments which in normal usage and acceptation are designated as contracts for the sale of property and not as "notes".

CONCLUSION

For the above reasons, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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